AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Tax Reform Recommendations on
Education & Family Benefits

Submitted to the House Committee on Ways & Means
Tax Reform Working Group on Education and Family Benefits

April 2013

AICPA's Tax Reform Recommendations on
Education and Family Benefits Issues
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Proposal: Harmonize and simplify education-related tax provisions

Present Law

Included in the Internal Revenue Code (IRC or "Code") are education incentives that may be divided into two general categories: (1) those that are intended to help taxpayers meet current higher education expenses and (2) those that encourage taxpayers to save for future higher education expenses.

The first category includes provisions that may be divided into three main subcategories: (1) exclusions from taxable income such as scholarships (section 117), employer-provided education assistance (section 127) and working-condition fringe benefits (section 132); (2) individual deductions, including the student loan interest deduction (section 221) and the tuition and fees deduction (section 222); and (3) individual credits, including the American Opportunity Tax Credit (previously the Hope Credit) and Lifetime Learning Credit (section 25A).

The second category, intended to fund future education, includes educational savings bonds (section 135), qualified tuition programs (section 529), and Coverdell Education Savings Accounts (section 530).

The various provisions contain numerous and differing eligibility rules for the provisions.

Description of Proposal

Tax benefits for higher education should be simplified and harmonized.[1] Specifically, we recommend the following provisions:

1. Replace tax incentives (i.e., Hope Credit, American Opportunity Tax Credit, Lifetime Learning Credit and the tuition and fees deduction) intended to help taxpayers meet current higher education expenses with one new or revised credit, and provide for an appropriate transition period. Combining features of these into one credit would simplify the tax benefits and remove duplicative provisions relating to higher education expenses.

    a. The credit should be on a "per student" rather than a "per taxpayer" basis, to assure every student is eligible regardless of family size.
    b. The credit should be available for any year of post-secondary education, including graduate-level and professional degree courses.
    c. The credit should be available only to students who are enrolled in a degree, certificate, or other program leading to a recognized educational credential at an

[1] The AICPA submitted testimony to the Senate Finance Committee hearing on Education Tax Incentives and Tax Reform on July 25, 2012.

institution of higher education and are carrying at least ½ the normal full-time work load for the course of study the student is pursuing.

d. The tax return reporting requirement should continue including the social security number (SSN) of the student associated with the expenses claimed with respect to the credit taken for the tax year. Accordingly, amounts claimed over time could be tracked by the student's SSN. These changes may result in improved compliance and enforcement.
e. The credit should be 100 percent refundable and phased out for high-income taxpayers. The phase-out limitations should be consistent with any other education-related incentive.
f. The credit should be claimed on the parent's return as long as the child is a qualifying dependent of the parent.

2. Create a uniform definition of "qualified higher education expenses" (QHEE) for all education-related tax provisions. Specifically, QHEE should include tuition, books, fees, supplies and equipment. Also, the terms "special needs services" and "special needs beneficiary" should be clearly defined.

3. If it is determined that phase-outs are necessary, coordinate the phase-out amounts for the student loan interest deduction and the educational savings bonds and Coverdell Education Savings Accounts exclusions with the new or revised tax credit intended to help taxpayers meet current higher education expenses. All education-related tax provisions should have the same AGI limitations. The concern for excessively high marginal rates resulting from coordinating phase-out provisions should be alleviated by substituting one credit for the several benefits that exist today. In addition, any remaining concerns could be addressed by widening the phase-out range, which would still permit coordination that could simplify matters for taxpayers and improve their understanding of eligibility.

Analysis

For many taxpayers, analysis and application of the intended incentives are too cumbersome compared with the benefits received. The Government Accountability Office (GAO) analyzed 2009 data for tax returns with information on education expenses and found that about 14 percent of filers (1.5 million of nearly 11 million eligible taxpayers) failed to claim a credit or deduction in which they were eligible. On average, these filers lost a tax benefit of $466 (GAO 12-560 Report to the Senate Finance Committee). Further, according to GAO research, although the number of taxpayers using the educational tax credits is growing quickly, the complexity of the tax provisions prevents hundreds of thousands of taxpayers from claiming tax benefits to which they are entitled or which would be most advantageous to them. Finally, there is evidence that the regressive nature of the provisions prevents low-income taxpayers from getting the tax benefit that Congress envisioned.

The complexity and interaction among the various provisions is a recurring theme. At the Spring 2008 House Ways and Means hearing on higher education tax incentives, Karen Gilbreath Sowell, Treasury's deputy assistant secretary for tax policy, commented that "with more than ten million families claiming tax benefits to help finance higher education each year, Congress must ensure that these benefits work as intended" and that "the complexity of the education tax incentives increases record-keeping and reporting burden on taxpayers and makes it difficult for the IRS to monitor compliance."

For example, eligibility for one of the two education credits depends on numerous factors, including the academic year in which the child is in school, the timing of tuition payments, the nature and timing of other eligible expenditures, and the adjusted gross income level of the parents (or possibly the student). In a given year, a parent also may be entitled to different credits for different children, while in subsequent years credits may be available for one child but not another. Further complicating the statutory scheme, the Code precludes use of the Lifetime or Hope (American Opportunity Tax) Credit if the child also receives tax benefits from education savings accounts. Although the child can elect out of such benefits, this decision also entails additional analysis.

An additional complicating factor is the phase-out of eligibility based on various AGI levels in six of the provisions. This requires taxpayers to make numerous calculations to determine eligibility for the various incentives. Since there are so many individual tests that must be satisfied for each benefit, taxpayers may inadvertently lose the benefits of a particular incentive because they either do not understand the provision or because they pay tuition or other qualifying expenses during the wrong tax year.

In addition to the complexity described above, there is evidence that erroneous application of education credits is making a significant contribution to the "Tax Gap." A report issued by the Treasury Inspector General for Tax Administration (TIGTA) in 2011 states that education credits of approximately $3.2 billion ($1.6 billion in refundable credits and $1.6 billion in nonrefundable credits) appear to be erroneous.[2] Over four years, erroneous education credits could potentially reach $12.8 billion.[3]

In terms of tax policy, the numerous tax incentives to assist with college expenses are not the only way the federal government provides assistance to college students and their families. Through the Department of Education, the federal government assists low-income individuals through various scholarship and grant programs. We encourage Congress to consider all of these programs together to determine if the desired goals are being met in an effective and efficient manner. The current tax provisions do not always meet the goal of helping low- to middle-income families with college expenses. Consideration should be given to where assistance can best be provided through the tax law (such as incentives to save for future college expenses) versus grant and scholarship

[2] Treasury Inspector General for Tax Administration Report 2011-41-083, Billions of Dollars in Education Credits Appear to Be Erroneous (September 16, 2011).
[3] *Id.*

programs while the student is in college (where assistance is needed at the start of the school year rather than when the tax return is filed). Consideration should also be given to identifying the targeted income group to whom the federal government should be providing financial assistance for higher education expenses. When assessing whether this goal is met, aid distributed through scholarships, grants or tax provisions should be considered.

Conclusion/Recommendation

Education-related tax provisions should be simplified as suggested above so that taxpayers better understand the rules and can both claim and comply with them in a cost-efficient manner. Such simplification would also improve the transparency and visibility of such tax provisions and allow the monitoring of compliance with the provisions. Simplification of the education-related tax provisions would increase the benefits going to the targeted taxpayers, and lower the cost of administering the tax system.

Proposal: Simplify the provisions for calculating the tax on unearned income of a child by removing the link with the parent's income tax return and by applying the income tax rates for estates and trusts

Present Law

Section 1(g) of the Internal Revenue Code taxes a portion of the unearned income of a child at the parent's marginal tax rate ("Kiddie Tax"). A child is defined as any child who is (1) under the age of 18; (2) age 18 at the end of the year and who did not have earned income that was more than half of the child's support; or, (3) a full-time student under the age of 24 who did not have earned income that was more than half of the child's support. Specifically, the provision applies in cases where (1) the child's unearned income was more than $2,000; (2) the child is required to file a tax return; (3) either parent of the child is alive at the close of the year; and, (4) the child does not file a joint return for the taxable year.

The marginal tax rate of the individual with the greater taxable income is used in the case of parents filing separately. In the case of parents who are not married, the marginal tax rate of the custodial parent is used to determine the tax liability on net unearned income. Net unearned income is the amount of unearned income above $1,000 plus the greater of $1,000 or itemized deductions directly connected to producing unearned income. When the provisions of section 1(g) apply to more than one child in the family, each child's share of the parental tax is apportioned ratably based on the ratio of the child's net unearned income to the total net unearned income of all children.

Section 1(g)(6) requires the parent to provide his/her taxpayer identification number to the child for inclusion on the child's tax return. Parents can elect to include their children's interest and dividend income (including capital gain distributions) on their tax return. However, the election is not available for parents of a child if such child has any earned income, unearned income of $10,000 or more (for 2013), unearned income other that interest, dividends and capital gain distributions, withholding, or estimated tax payments.

Description of Proposal

We recommend the repeal of the provisions linking a child's taxable income to his/her parents' and siblings' taxable income. Income (other than capital gains) subject to this tax should be taxed using the income tax rates for estates and trusts. Income from capital gains should be taxed at the capital gains rates with one change; we believe the 0 percent rate for capital gains should not apply to children's unearned income.

Further, the election to include a child's income on the parent's return should be eliminated to facilitate the complete de-coupling of the link between the computation of the child's tax liability and the parent's tax liability.

Analysis

The Kiddie Tax adds significant complexity to the computation of a child's tax liability. As a result of this complexity, the Internal Revenue Service (IRS or "Service") issued Publication 929, a 37-page booklet that provides worksheets to assist the taxpayer, or return preparer, with calculating the child's taxable income and tax liability. In addition to the complex calculations, several challenges arise in complying with the rules of the statute:

- Difficulty in getting information about the applicable tax rate: Parents may either refuse to provide the tax rate or, if divorced, one parent may refuse to cooperate with the other in providing the information. Without this information, the tax preparer may be forced to calculate the child's tax unfairly at the highest rate.

- Qualified dividends or capital gain distributions: The IRS requires qualified dividends and capital gain distributions to be allocated between the first $2,000 (in 2013) of unearned income and the portion of the child's unearned income in excess of $2,000, thus making the computation burdensome.

- Interrelationship with parents'/siblings' returns: If either the parents or siblings file amended returns, the child must file an amended return. The fact that amended returns have been filed may not be readily known.

- Alternative minimum tax (AMT): The Kiddie Tax provision only considers the regular tax of section 1 and not the AMT of section 55. Therefore, the way the current rules are written, if a parent must pay AMT, the child's income is still taxed at the parent's regular marginal tax rate, while the parent is taxed at the AMT rate without taking into account the child's income or the child's regular tax liability. The end result is the taxation of the child's income at a rate higher than the rate that applies to the parent.

Removing the linkage to parental and sibling returns would allow a child's return to stand on its own. Complications due to missing information on one return, matrimonial issues and unintended AMT problems would be eliminated.

Conclusion/Recommendation

The AICPA believes the additional tax revenue generated by the Kiddie Tax is most likely insignificant when compared to the complexity of the calculations. Taxing the net unearned income of a child at the tax rates for estates and trusts rather than at a rate linked to that of family members would eliminate a significant amount of complexity and several compliance challenges, while still accomplishing the original intent behind the Kiddie Tax. The Tax Reform Act of 1986 lowered tax rates and broadened the income base by eliminating various tax shelters which were utilized by high income individuals. The Kiddie Tax was one such provision which targeted taxpayers who were attempting to shift income to family members in lower tax brackets. In recommending the Kiddie Tax, the Joint Committee on Taxation's General Explanation of the Tax Reform Act of 1986 wrote, "The present-law rules governing the taxation of minor children provide inappropriate tax incentives to shift income-producing assets among family members."

Proposal: Standardize the allowable mileage rates for business expense, medical expense, mileage expense and charitable contribution purposes

Present Law

A standard mileage allowance, generally determined annually, is allowed to taxpayers in determining their expenses related to employment (56.5 cents per mile beginning January 1, 2013). Further, a standard mileage allowance, also generally determined annually, is allowed to taxpayers for purposes of medical and moving expense deductions (24 cents per mile beginning January 1, 2013). When necessary, the IRS has the authority to adjust these rates at any time (as they did in mid-year 2011 to reflect the extraordinary rise in gasoline prices). In contrast, the mileage rate allowed for charitable contribution deduction purposes is set by law at 14 cents a mile. Prior to 1984, the IRS had the authority to set this rate as well.

Note: Legislation (H.R. 6854 and S. 3246) was introduced in the 110th Congress to allow the IRS to once again set the charitable contribution deduction mileage rate and standardize it at the same amount as that allowed for medical and moving expenses. Separate legislation (S. 3429) also was introduced in the 110th Congress to set the charitable deduction mileage rate at 70 percent of the business mileage rate. In the 111th Congress, three bills (H.R. 345, H.R. 590, and S. 285) were introduced to set the charitable contribution mileage deduction rate at the same amount as that allowed for business expenses.

Description of Proposal

Allow two mileage rates: one for business expenses and another for all non-business purposes (charitable, medical and moving expenses). The non-business rate should be set by the IRS at a percentage of the business rate, rounded to the nearest half cent. The business rate should be adjusted annually and possibly semi-annually in certain circumstances. The starting point would be the business rate in effect at the time of enactment.

Analysis

Currently, taxpayers often need to apply at least two and sometimes three different mileage rates on a single return. The proposal would reduce these numbers to one and occasionally two rates per return. Allowing the IRS to set a fair rate for charitable contribution mileage would recognize the vital role volunteers play in our society. Linking all mileage rate allowances to a single standard and adjusting those rates at least annually would bring fairness and equity to the process. In addition, the IRS's annual calculation of these rates would be simplified.

Conclusion/Recommendation

Congress should allow the IRS once again to set the charitable contribution deduction mileage rate, which should be standardized at the same amount as that allowed for other non-business purposes (medical and moving expenses). This single rate should be set at a percentage of the business mileage allowance. All mileage allowance rates should be adjusted on an annual basis, possibly with a mid-year adjustment.

Proposal: Allow certain attorney fees and court costs as deductions for AGI

Present Law

In computing adjusted gross income (AGI), individuals are allowed to treat costs related to certain types of litigation or award recoveries as deductible for AGI. Attorney fees for other types of non-business litigation, if deductible, are generally treated as expenses for the production of income under section 212 of the Internal Revenue Code. As such, these expenses are treated as miscellaneous itemized deductions subject to the 2 percent of AGI limitation of section 67 and the overall limitation of section 68 on itemized deductions. In addition, miscellaneous itemized deductions are not deductible in computing alternative minimum tax (AMT). Thus, despite the fact that legal fees are incurred and gross income is derived from the litigation or action, taxpayers are not treated similarly with respect to the tax treatment of their legal fees.

Section 62(a)(20) enacted as part of the American Jobs Creation Act of 2004 (PL 108-357) provides that attorney fees and court costs connected with the following types of actions are deductible for AGI:

> Unlawful discrimination claim (as defined at section 62(e) which lists 18 types of "unlawful discrimination" actions, such as certain violations under the Civil Rights Act of 1991, the National Labor Relations Act, the Fair Labor Standards Act of 1938, the Family and Medical Leave Act of 1993 and several others);
> Claim of violation of subchapter III of chapter 37 of US Code Title 31; and
> Claim under § 1862(b)(3)(A) of the Social Security Act.

The attorney fee and court cost deduction may not exceed the amount included in gross income from the judgment or settlement of the associated claim.

Section 62(a)(21) was enacted as part of the Tax Relief and Health Care Act of 2006 (PL 109-432). This provision allows a deduction for AGI for attorney fees and court costs for any award received under section 7623(b) related to whistleblower awards. The deduction is limited to the amount of the award included in gross income for the year.

Description of Proposal

Section 62 should be modified to allow a deduction for AGI for any attorney fees and court costs paid or incurred by a taxpayer related to any litigation award or settlement that is included in gross income.

Analysis

The Tax Reform Act of 1986 modified the rules on miscellaneous itemized deductions by making them deductible only to the extent they exceed 2 percent of the taxpayer's AGI. The primary rationale for the change was simplification. The committee report provided the following reasons for change:[4]

> The committee believes that the present-law treatment of employee business expenses, investment expenses and other miscellaneous itemized deductions fosters significant complexity. For taxpayers who anticipate claiming itemized deductions, present law effectively requires extensive recordkeeping with regard to what commonly are small expenditures. Moreover, the fact that small amounts typically are involved presents significant administrative and enforcement problems for the Internal Revenue Service. These problems are exacerbated by the fact that taxpayers may frequently make errors of law regarding what types of expenditures are properly allowable as miscellaneous itemized deductions.
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> Since many taxpayers incur some expenses that are allowable as miscellaneous itemized deductions, but these expenses commonly are small in amount, the committee believes that the complexity created by present law is undesirable. At the same time, the committee believes that taxpayers with unusually large employee business or investment expenses should be permitted an itemized deduction reflecting that fact. Similarly, in the case of medical expenses and casualty losses, a floor is provided under present law to limit those deductions to unusual expenditures that may significantly affect the individual's disposable income.
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> Accordingly, the committee believes that the imposition of a one percent floor on miscellaneous itemized deductions constitutes a desirable simplification of the tax law. This floor will relieve taxpayers of the burden of recordkeeping, unless they expect to incur expenditures in excess of the percentage floor. Also, the floor will relieve the Internal Revenue Service of the burden of auditing deductions for such expenditures when not significant in aggregate amount.
>
> The committee also believes that the distinction under present law between employee business expenses (other than reimbursements) that are allowable above-the-line, and such expenses that are allowable

[4] Tax Reform Act of 1986 (PL 99-514; 10/22/86), House explanation.

> only as itemized deductions, is not supportable. The reason for allowing these expenses as deductions (i.e., the fact that they may constitute costs of earning income) and the reasons for imposing a percentage floor apply equally to both types of expenses.

Despite the fact that some types of miscellaneous deductions are incurred to produce gross income, in 1986, Congress sought to limit the deductibility of many of these deductions, including non-business attorney fees associated with litigation and settlement awards. At that time, Congress treated all such attorney fees and court costs of producing non-business awards, similarly. However, in 2004, Congress started to treat one type of litigation expenses differently, and did so again in 2006 with one more type of litigation expense. These changes involving subsets of attorney fees, created an inequity in the tax law regarding the treatment of deductions.

Given that all attorney fees and court costs incurred to generate taxable litigation and settlement awards are costs to produce income and that there is little complexity in tracking these specific and often sizable amounts, the principles of equity and fairness warrant treating <u>all</u> attorney fees and court costs the same regardless of the nature of the taxable damages award. Thus, the change made to section 62(a) in 2004 and 2006 should be broadened to include all attorney fees and court costs that relate to taxable awards.

Conclusion/Recommendation

Section 62(a)(20) and (21) should be replaced with one provision to read as follows:

> Section 62(a)(20) Attorney fees related to taxable awards
>
> Any deduction allowable under this chapter for attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any award includible in gross income, with appropriate adjustments for amounts previously deducted. The preceding sentence shall not apply to any deduction in excess of the amount includible in the taxpayer's gross income for the taxable year on account of such award.

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Proposal: Clarify and simplify reporting of cancellation of debt income

Present Law

Under Treas. Reg. § 1.6050P-1, an entity that discharges a debt to any person of at least $600 during a year, must file a Form 1099-C. For these purposes, a discharge of indebtedness is deemed to occur when an identifiable event occurs whether or not an actual discharge of indebtedness has occurred on or before the date of the identifiable event.

Description of Proposal

The AICPA proposes that section 6050P, returns relating to the cancellation of indebtedness by certain entities, should be modified to provide that Form 1099-C should be issued only if the borrower's legal obligation to repay has been terminated.

Analysis

Frequently taxpayers who believe they have settled a debt, foreclosure or bankruptcy issue receive a Form 1099-C from the bank or other institution and are unaware that the unpaid debt issue has been forwarded to a collection organization that begins a process of seeking to negotiate or collect as much as they can.

Unaware of their legal rights or obligations, the taxpayers are understandably confused and do not recognize that the receipt of this IRS form does not have any bearing on these collection efforts nor are these collection efforts constrained if the taxpayer produces these forms.

Conclusion/Recommendation

We recommend that borrowers should not be issued a Form 1099-C unless their legal obligation to repay a loan has been terminated.